



Understanding Retirement Annuities

Annuities characterized by payments

Understanding annuities can be difficult because the term *annuity* is used to describe several different things. In general, annuities are associated with a stream of payments. On the one hand, the stream of payments can constitute contributions toward building a nest egg for retirement. On the other, it can constitute income payments received from a nest egg after retirement. The term is also used to describe a contractual arrangement where an amount is paid to insure regular payments for a stated period of time.

Payments-contributed annuities

Payments-contributed annuities are most commonly exemplified by the Individual Retirement Account or IRA. Payment are made monthly or annually to an interest-bearing or otherwise invested account in order to accumulate funds for one's retirement. This type of account allows for tax-deductible contributions and tax-deferred earnings. This means that tax on income used for the contributions and the money it earns are not paid until withdrawals are made from the account. Other examples of this type of annuity include various TSAs (Tax Sheltered Annuities) such as the 401(k) and 403(b) retirement plans.

Among annuity specialists, the IRA and these other types of TSAs are called Flexible Premium Deferred Annuities—quite a mouthful. Flexible means that the payments or premiums may vary in size and frequency. Deferred means that the payment or withdrawal of retirement funds, along with the taxes, is deferred rather than immediate. With a payments-contributed annuity, the stream of annuity payments builds the nest egg.

These types of annuities may also be termed variable or fixed depending on the nature of the underlying investment. Fixed annuities offer so-called fixed returns from conservative interest-bearing investment instruments, much like a savings account. These rates actually vary over time, but they are fixed for periods of time. Variable annuities offer underlying investments whose returns vary. These usually include stock and bond portfolios in addition to a fixed option.



Payments-received annuities

Payments-received annuities are most commonly exemplified by the disbursement of funds in equal monthly payments from a retirement nest egg. While the nest egg is invested, periodic withdrawals are made over time in amounts that will gradually exhaust the nest egg. This describes what happens when individuals maintain control over their own nest eggs

and annuitize them by withdrawing payments that will exhaust their fund over the period of their expected retirement.

Quite frequently, instead of annuitizing one's own nest egg, the nest egg is used to purchase a contract that guarantees monthly income payments of a specific amount. This, in fact, is the most common use of nest eggs or pension plans that offer specific payments for life or a certain period of time based on the amount accumulated. The accumulated value is used to purchase what annuity specialists call a Single Premium Immediate Annuity from an insurance company. Single premium refers to the single lump sum which is converted to or used to buy the annuity contract. Immediate refers to the immediate start of regular payments made to the annuitant. The amount and duration of the guaranteed payments are based on the premium amount and the annuitant's choice of settlement or payout options.

The attraction of an SPIA is that a certain level and duration of payments are guaranteed and the annuitant does not need to worry about managing and investing the nest egg. But direct control of the nest egg is lost in the process. One cannot invest for a higher return, withdraw a larger payment for needed expenses, or get his or her money back out of the annuity without paying a very substantial surrender charge.

For further information and annuity ratings, consult three of the 12 monthly issues of *Best's Policy Reports* (March, October, and November) These may be ordered from A.M. Best Company, Ambest Road, Oldwick, NJ, 08858.

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